

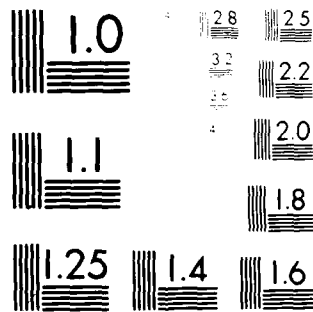
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TERMINATING THE AUDIT OF THE NATIONAL FLOOD INSURANCE PROGRAM'S--ETC(U)
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UNCLASSIFIED GAO/AFMD-81-93

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

ACCOUNTING AND FINANCIAL
MANAGEMENT DIVISION

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SEPTEMBER 21, 1981

The Honorable Louis O. Giuffrida
Director, Federal Emergency
Management Agency

Dear Mr. Giuffrida:

Subject: Terminating the Audit of the National Flood
Insurance Program's Fiscal 1980 Financial
Statements. (AFMD-81-93)

In July 1980, we began auditing the Federal Insurance Admin-
istration's (FIA's) National Flood Insurance Program (NFIP). The
objective of the audit was to express an opinion on the NFIP's
fiscal 1980 financial statements. We will not meet this objec-
tive, however, because the Federal Emergency Management Agency
(FEMA) has been unable to produce financial statements for NFIP.

Pursuant to the Government Corporation Control Act, our re-
port to the Congress on NFIP was due April 15, 6-1/2 months after
the close of the fiscal year. Since that date has passed and we
have entered the last quarter of fiscal 1981, it was no longer
useful for us to continue auditing the 1980 statements. Accord-
ingly, we stopped the 1980 audit and redirected our efforts toward
a more indepth study of the internal control system.

FEMA's inability to produce financial statements for NFIP is
due to several problems which must be addressed. The rest of this
report discusses these problems and recommends corrective action.

BACKGROUND

The National Flood Insurance Act of 1968 (42 U.S.C. 4001)
subjects NFIP to the Government Corporation Control Act (31 U.S.C.
841-869) which, in turn, requires the preparation of annual finan-
cial statements. In order to produce financial statements that
are in accordance with generally accepted accounting principles,
it is essential to have an accounting and reporting system that
provides accurate, complete, and timely reports which can be used
to prepare such financial statements. In the case of NFIP, three
entities are ultimately responsible for financial statements--
Electronic Data Systems Federal Corporation (EDSF) and FIA share
operating responsibility, and FEMA has primary reporting responsi-
bility. All three entities must ensure that all transactions af-
fecting NFIP are accounted for and reported properly within reason-
able time limits.

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EDSF is responsible for the day-to-day insurance operations of NFIP. In its capacity as prime contractor, 1/ EDSF is responsible for recordkeeping and clerical duties, including maintaining all records on policyholders, accepting premiums, and settling claims. EDSF is also responsible for providing FIA with statistical and financial data on the insurance operations.

FIA is responsible for contract monitoring and it employs onsite representatives to do this. FIA receives monthly reports from EDSF covering the work accomplished during the month. A segment of the monthly report summarizes financial information based on the month's transactions. As the primary recipient of the report and monitor of contractor performance, FIA is responsible for assuring that the financial information reported by the contractor is accurate, complete, and timely.

FEMA is responsible for financial reporting and also receives the financial information segment of the monthly report from EDSF. The FEMA Accounting Branch is responsible for assembling this information, along with other separately recorded NFIP transactions, and preparing the NFIP financial statements in accordance with generally accepted accounting principles.

→ In summary, a financial reporting system was to have been in place that should have enabled FEMA (Federal Emergency Management Agency) to effectively carry out its responsibilities under the Government Corporation Control Act. EDSF was to provide the necessary monthly reports of NFIP's insurance operations; FIA (Federal Insurance Administration), as program monitor, was to assure that EDSF provided accurate, complete, and timely data; and FEMA was to incorporate the financial information into its own accounting system for later reporting needs, including preparation of NFIP financial statements.

(Electronic Data Systems Federal Corporation)
The inability to prepare financial statements reflects negatively on the adequacy of NFIP's accounting system, the financial management of the program, and management's commitment to a sound system of internal accounting controls. We believe this is due to the following weaknesses:

- FEMA Accounting did not carry out its accounting control responsibilities for the Flood Program,
- The contract with the insurance program operator, EDSF, did not specify essential controls and financial reports,

1/ EDSF is now in the fourth year of a 5-year contract. The total estimated cost of the contract through year four is about \$78 million. The fifth year of the EDSF contract expires November 3, 1982. The contract will then be open to competitive bidding.

- (3) → EDSF did not maintain adequate accounting controls over financial reporting; and
- (4) → FIA did not adequately monitor EDSF operations.

FEMA DID NOT CARRY OUT ITS
ACCOUNTING CONTROL RESPONSIBILITIES

Throughout fiscal 1980, FEMA Accounting did not maintain accounting control over NFIP. Prior to fiscal 1980, the accounting and financial reporting responsibility for the Flood Program was assigned to the Department of Housing and Urban Development (HUD). When the responsibility was transferred to FEMA on October 1, 1979, HUD provided FEMA Accounting with NFIP records and accounts. FEMA Accounting, however, failed to maintain the recordkeeping and reporting. Even though it claimed to be unaware of the Government Corporation Control Act's reporting requirements until we began our audit in July 1980, fundamental financial management principles should have dictated at least minimal recordkeeping.

Since FEMA Accounting had not maintained essential NFIP financial records, it could not answer our request for financial statements. When we initiated our audit, we informed FEMA Accounting and FIA officials of the financial statement requirements. We pointed out that the statements must reflect the entire Flood Program, which consists of the National Flood Insurance Fund (funded by Treasury borrowings) and flood studies and surveys (funded by annual appropriations). FEMA Accounting has overall financial accounting and reporting responsibilities for both activities. Financial statements for the Flood Program had not been prepared since our 1977 audit, but we were assured that the statements could be prepared quickly. However, without adequate records, FEMA Accounting could not prepare satisfactory NFIP financial statements.

Nonetheless, some effort was made to prepare the statements. An FIA employee assigned to monitor the EDSF contract did the initial work on the statements and assembled enough information to produce trial balances for the National Flood Insurance Fund. From these trial balances, FEMA Accounting attempted to prepare draft financial statements. But, since it had made no effort to determine the account balances for flood studies and surveys, the draft statements did not include account balances approximating \$500 million. Those balances could not be determined because FEMA Accounting had not kept current with the appropriation transactions, making it virtually impossible to prepare supporting statements without a great deal of work. In addition to excluding material account balances, the draft statements were not prepared in accordance with generally accepted accounting principles. FEMA Accounting personnel indicated they were not proficient enough in accounting to prepare such financial statements.

We continued to tell managers we needed the NFIP financial statements. In December 1980, we wrote to the FEMA Director to explain the deficiencies of the draft financial statements and our need to have complete statements promptly. In January, we agreed to provide assistance in the form of advice, but pointed out that we could not prepare the financial statements for FEMA. In February, we found that FEMA Accounting still had not prepared the account balances for studies and surveys. As of this writing, we still have not received the NFIP financial statements.

THE CONTRACT WITH EDSF DID NOT REQUIRE
ESSENTIAL CONTROLS AND FINANCIAL REPORTS

Meanwhile, we attempted to audit the National Flood Insurance Fund account balances produced by an accounting system maintained by EDSF. Our work revealed further weaknesses which we believe were the result of the fact that the contract with EDSF lacked specificity. There is no specific clause in the contract that requires EDSF to maintain proper accounting controls and provide accounting information essential for preparing financial statements for the Fund.

The contract does not contain a provision clearly defining the contractor's responsibilities for accounting and financial reporting for purposes of the Government Corporation Control Act. Paragraph VII of the contract provides for the development of an improved ADP system for financial and audit control procedures. No system has been developed. The contract does not contain a specific requirement for accounting procedures, records, and reports maintained and prepared in accordance with generally accepted accounting principles. These are essential elements in the preparation of accurate and timely financial statements. Nor is there a provision requiring that the interim system adhere to any accounting principles and standards.

We do not believe the interim contract language is explicit enough for purposes of the Government Corporation Control Act. It states that:

"The contractor shall separately account, on an automated or manual basis, for the flood insurance business on a general ledger basis, in a format reasonably approved by the GTR [Government Technical Representative], and sufficient to produce the information required by the Summary Statement of Operations [monthly report] * * *."

The contract does not contain a provision requiring that proper accounting controls are to be established and maintained to ensure that the recording, summarizing, and reporting of all transactions are accurate, complete, and timely, and in accordance with generally accepted accounting principles and standards. Such controls are essential to safeguarding assets as well as producing reliable financial statements and reports.

EDSF DID NOT MAINTAIN PROPER CONTROLS
OVER FINANCIAL REPORTING

EDSF did not establish adequate controls to ensure the accuracy of monthly reports. A fundamental auditing prerequisite is that a reporting entity be able to demonstrate that reported amounts are supportable by the accounting system. EDSF, however, has not been able to substantiate the integrity of its financial reporting because its monthly reports lack the necessary audit trail to the general ledger.

The seriousness of this situation became evident when EDSF gave FEMA general ledger account balances which were not reconciled. There were material differences between the general ledger balances and the monthly reports. The most significant differences were in the cash, claims expense, and drafts outstanding accounts. Until these differences are resolved, the NFIP financial statements cannot be finished.

EDSF was unable to satisfactorily explain why the balances in the monthly reports were not reconcilable to the general ledger. We believe the reason was EDSF's failure to maintain proper controls over the preparation of its monthly financial reports. Specifically, for 3-1/2 years of the contract, EDSF did not reconcile the cumulative totals reported to FIA with its general ledger account balances. A reconciliation is an essential internal accounting control technique which is used to ensure the completeness of processing and, ultimately, the reliability of the financial statements.

The difference between the general ledger account balances and the cumulative total of monthly reports is increasing. In preparing the monthly reports, EDSF analyzes the transactions posted to the general ledger during the month and makes adjustments to arrive at the monthly report balances. The balances are then added to the previous months' to derive a cumulative total. Since EDSF does not reconcile the general ledger balances with the cumulative monthly report totals, it is unable to determine if errors were made in preparing monthly figures and whether all adjustments were properly posted. Thus, adjustment differences and errors have been carried forward year after year and, as more occurred, the discrepancy between the cumulative monthly totals and the general ledger balances has increased.

In summary, EDSF experienced problems with the general ledger and monthly financial reports because it neglected fundamental accounting responsibilities. This situation also raises questions as to the reliability of other EDSF data. As of this writing, the problems have not been resolved.

FIA DID NOT ADEQUATELY
MONITOR CONTRACTOR PERFORMANCE

FIA did not adequately carry out its responsibilities for monitoring EDSF accounting and financial reporting operations. When the contract was awarded, FIA assigned a cadre of monitors, located at the contractor's facility, to observe and report on contractor performance in a number of key areas. Financial systems and reporting was one of the key areas. The duties of the financial system monitors included "reviewing the financial controls and accounting procedures to insure that adequate control of Federal funds is maintained." We discussed this responsibility with FIA personnel at the contractor's facility and they contended that their monitoring duties did not include the type of review that would have disclosed a lack of controls over the monthly financial reporting. They believed such a review would be beneficial, but that it would be more appropriate as an audit function provided by FEMA Accounting or an independent audit group.

Although we agree that periodic independent audits are necessary, we believe that the monitors also have an ongoing responsibility to ensure that the data reported by EDSF is accurate and reliable. Since the contract requires the contractor to maintain an accounting system that can produce the financial data for the monthly reports, we believe that the monitors must ensure that the data is, in fact, sufficient. Further, we question how FIA can ensure that "adequate control of Federal funds is being maintained" when the reported figures cannot be supported by accounting records.

We believe that because this responsibility was not performed adequately it contributed to weakening the integrity of EDSF financial reporting. Had the monitors closely reviewed the accounting procedures and financial reports, the inadequate recordkeeping practices probably would have been identified and corrected.

CONCLUSIONS AND RECOMMENDATIONS

The Government Corporation Control Act requires annual financial statements and NFIP is subject to this requirement. No financial statements have been prepared since our last audit in 1977 and FEMA has been unable to give us satisfactory fiscal 1980 financial statements. Thus, we were forced to stop our audit. The inability to provide the statements was caused by FEMA Accounting's failure to carry out its accounting control and reporting responsibilities. FEMA Accounting personnel said they did not maintain comprehensive accounting information because they were unaware of their responsibility to prepare financial statements. FEMA was further deficient in not having personnel with the expertise necessary to prepare financial statements in accordance with generally accepted accounting principles. Additional problems arose because the contract did not contain a provision requiring the contractor to account for and report transactions in accordance with generally

accepted accounting principles, and due to the contractor's failure to maintain proper controls over financial reporting. FIA compounded these problems by failing to adequately monitor the contractor's accounting and reporting performance.

FEMA Accounting, FIA, and EDSF are trying to correct the account balance discrepancies. Although this needs to be done, it will not resolve the fundamental weaknesses in accounting for NFIP operations. Thus, we recommend that FEMA quickly provide accurate and timely financial statements as required by law by taking the following actions:

- Staff the FEMA Accounting Branch with qualified accountants and charge them to improve the NFIP accounting and reporting system.
- Require the contractor, EDSF, to use an accounting system which provides for financial statements prepared in accordance with generally accepted accounting principles and standards.
- Require EDSF, as insurance program operator, to establish and maintain recordkeeping procedures sufficient to provide FEMA and FIA with accurate, complete, and timely information.
- Emphasize to FIA financial monitors that they are responsible for ensuring that adequate control is maintained over Federal funds, and that their duties include monitoring all contractor accounting controls and financial reporting procedures.

AGENCY COMMENTS AND OUR EVALUATION

We received comments on our draft of this report from the Federal Emergency Management Agency and Electronic Data Systems Federal Corporation. FEMA acknowledged the existence of the problems we identified, and indicated that a number of actions are being initiated to resolve them. EDSF, however, disputed our statement that it neglected fundamental accounting responsibilities in not establishing adequate controls over monthly reports.

EDSF contends that they provided us with the necessary documentation to support an audit trail for the monthly reports. It did give us a detailed explanation of the procedures used to prepare the report figures from general ledger figures, and we used them. However, in spite of our efforts, the efforts of FEMA, and EDSF's own Accounting Department, the balances in the general ledger could not be traced to the cumulative totals in the monthly reports. This was because EDSF did not do essential reconciliations which are fundamental to ensuring reliable processing and financial reporting.

EDSF stated that such reconciliation would be difficult and impractical since, over the life of the contract, many report format changes were made at the direction of FEMA. We cannot comment on the degree of difficulty. However, we believe strongly that, since cumulative totals are derived from monthly figures and monthly figures are derived from general ledger account balances, there should be a direct tie between the cumulative totals and the general ledger account balances. Changing report formats, while disruptive, should not have caused a loss of control if EDSF had performed the necessary reconciliations from the start.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations. You must send the statement to the House Committee on Government Operations and the Senate Committee on Governmental Affairs within 60 days of the date of this report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of the report.

We appreciate the courtesies extended to our representatives during this effort. We are sending copies of this letter to the Director of the Office of Management and Budget, the chairmen of the House Committee on Government Operations, the Senate Committee on Governmental Affairs, and the House and Senate Committees on Appropriations.

Sincerely yours,


W. D. Campbell
Acting Director

